Chapter 8
Capital Gains and Losses

Income Tax Fundamentals 2012

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Martha Altus-Buller
Learning Objectives

- Define “capital asset” and holding period for long-term and short-term capital gains
- Calculate gain/loss on asset disposition
- Compute tax on capital gains and understand treatment of capital losses
- Identify treatment of §1231 assets and describe depreciation recapture rules
- Identify casualty loss treatment for personal and business purposes
- Outline gain deferral provisions on various transactions
- Identify tax treatment of voluntary conversions, sale of personal residence and like-kind exchanges
Define a Capital Asset

Capital assets are defined by exception

A capital asset is any asset *other than* inventory, receivables, copyrights, certain U.S. Government publications and depreciable or real property used in a trade or business.
Capital Gains and Losses

Sale/exchange of capital asset results in a capital gain or loss

- Although not defined precisely – “sale” is receipt of cash or release of debt and “exchange” requires transfer of ownership
- Capital gains and losses receive special tax treatment
- Tax treatment based on length of time property has been owned (called holding period)
Capital Assets - Holding Period

- Determining holding period is the first step in determining tax treatment.
- The holding period for capital assets is how long the taxpayer owned the asset.
  - *Long-term* assets are held for > 12 months.
  - *Short-term* assets are held for ≤ 12 months.
Realized Gains/Losses vs. Recognized Gains/Losses

Realization of gain or loss requires the “sale or exchange” of an asset.

Amount realized
less: Adjusted basis of property
Realized gain (loss)
less: Allowed gain deferral
Recognized gain (loss)

*Models for these items are found on the next screens
Amount Realized

Amount Realized = Gross sales price - Selling expenses

- Gross sales price is the amount received by the seller from the buyer and equals
  - Cash and fair market value (FMV) of property received
    - plus
  - Seller’s liability assumed by or paid for by the buyer
    - less
  - Selling expenses (costs paid to transfer property)
Example

On 8/4/11, Juliana sold 326 shares of stock in Nanoplasma LLC that she had purchased 6/18/99. Her cost basis = $10,000; she sold the shares for $19,000 and paid a commission of $1,300.

Calculate the “amount realized” and “realized gain.”
Example
On 8/4/11, Juliana sold 326 shares of stock in Nanoplasma LLC that she had purchased 6/18/99. Her cost basis = $10,000; she sold it for $19,000 and paid a commission of $1,300. Calculate “amount realized” and “realized gain.”

Solution
Amount realized = $17,700 ($19,000 – 1,300)
Realized gain = $7,700 ($17,700 - 10,000)
Adjusted Basis

Original cost

plus: Capital improvements*

less: Accumulated depreciation

Adjusted basis

*Items that significantly result in an increase to property value or increases the useful life
Cost Basis for Stock

- Oftentimes difficult for taxpayers to track adjusted basis of stock
  - Depends upon whether stock was purchased, inherited or received as a gift
- Basis depends upon how acquired
  - If inherited, heir’s basis is fair market value at time of death (may not apply to large inheritances in 2010)
  - If acquired as gift, basis depends upon whether donee sells at a gain or loss

*Due to many errors in reporting basis on individual tax returns, Congress now requires brokers to report basis for certain sales for stock purchased on or after 1/1/11*
Net Capital Gains

- There are complex capital gain rules based on type of capital gain
- Study the table “Capital Gains & Applicable Tax Rates” in Section 8.4 and note the following:
  - Short-term capital gains - taxed at ordinary income rates
  - Long-term capital gains - taxed at preferred rates, (see next slide) depending on which bracket a taxpayer is normally in
  - Unrecaptured §1250 gain has differing rates, depending on which bracket a taxpayer is normally in
Net long-term capital gain (LTCG) rates depend upon regular tax bracket
- Taxed at 0% for taxpayers in 10% or 15% brackets
- Taxed at 15% for taxpayers in all other brackets

Collectibles held more than 12 months are taxed at a maximum rate of 28%

Unrecaptured depreciation on real estate is taxed at a maximum rate of 25%

These preferential rates are about to expire. Congress may pass new laws with different rates, or extend rates, or let preferential rates expire completely.
Tax Treatment for Net Short-term Capital Gains

- Short-term capital gains result from selling capital assets held less than or equal to one year
- Net short-term capital gain (STCG) is taxed as ordinary income
Calculating Net Capital Position

**Step 1:** Classify each item as short-term or long-term and net by groups

- Long-term gains netted against Long-term losses = Net Long-term Gain or Loss
- Short-term gains netted against Short-term losses = Net Short-term Gain or Loss
Calculating Net Capital Position

Step 2: If short-term & long-term net results are same sign: do not net! You will have both a STC and LTC gain or loss.

If net short-term & long-term are opposite signs:

Net the short-term gain or loss against the long-term gain or loss
Net Capital Losses

- Note that net capital losses (short-term and long-term) may be taken against ordinary income in amounts up to $3,000/year (with an indefinite carry forward)
- Must maintain ‘nature’ of capital loss (i.e. – short-term or long-term) when carrying it forward
  - In subsequent years, must deduct STCL first

Note: Must comply with ordering rules (on next screen)
Ordering Rules for Capital Losses

- When taxpayer has net capital loss position, must offset capital gains using ordering rules
  - Net STCL first reduce 28% gains
    - Then reduce 25% gains
    - Then reduce regular LTCG
  - Net LTCL first reduce 28% gains
    - Then reduce 25% gains
    - Then reduce regular STCG

Note: Sale of personal capital assets (like personal residence or automobile) does not generate a tax-deductible loss
Example
Shavril has the following capital gains and losses in the current year:

- Short-term capital loss: $(2,000)
- Long-term capital gain: 12,000
- Long-term capital loss carryover: $(7,000)*

*Carried forward from prior year

What is Shavril’s net capital position? In 2011, what are the tax implications for Shavril’s capital activities, if he’s in the 15% ordinary income tax bracket?
Solution

**Short-term (Step 1 – net short-term activities)**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term capital gains</td>
<td>$0</td>
</tr>
<tr>
<td>Short-term capital loss</td>
<td>$(2,000)</td>
</tr>
<tr>
<td>Net ST position</td>
<td>$(2,000)</td>
</tr>
</tbody>
</table>

**Long-term (Step 2 – net long-term activities)**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term capital gain</td>
<td>$12,000</td>
</tr>
<tr>
<td>Long-term capital loss carryover</td>
<td>$(7,000)</td>
</tr>
<tr>
<td>Net LT position</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

**(Step 3 – first two steps go in different directions, so net the results)**

<table>
<thead>
<tr>
<th>Description</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Net long-term capital gain</td>
<td>$(2,000) + 5,000</td>
</tr>
</tbody>
</table>

His $3,000 LTCG will be taxed at 0% because he is in the 15% ordinary income tax bracket.
### Capital Gain/Loss Example

**Example**

Thurber has several capital transactions in the current year as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Date Acquired</th>
<th>Date Sold</th>
<th>Selling Price</th>
<th>Cost Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jet Blue Bond</td>
<td>5/5/01</td>
<td>6/1/11</td>
<td>41,400</td>
<td>39,000</td>
</tr>
<tr>
<td>Micron Stock</td>
<td>8/3/10</td>
<td>6/1/11</td>
<td>11,000</td>
<td>12,300</td>
</tr>
<tr>
<td>AP Health</td>
<td>9/2/99</td>
<td>6/1/11</td>
<td>19,000</td>
<td>24,000</td>
</tr>
</tbody>
</table>

What is Thurber’s net capital position? If he has a carry forward, how much is it and what is the nature?
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<td>12,300</td>
</tr>
<tr>
<td>AP Health</td>
<td>2/2/99</td>
<td>6/1/11</td>
<td>19,000</td>
<td>24,000</td>
</tr>
</tbody>
</table>

What is Thurber’s net capital position? If he has a carry forward, how much is it and what is the nature?

Solution
Jet Blue LTCG = $2,400; Micron STCL = $1,300; AP Health LTCL = $5,000.

Net long-term capital loss = $2,600. Since he has both net short-term and long-term losses, deduct net short-term loss and $1,700 of net long-term loss. Thurber will carry forward a net long-term capital loss of $900 to 2012.
**Character of Gain or Loss**

<table>
<thead>
<tr>
<th>Amount realized from disposition</th>
<th>less: Adjusted basis of property</th>
</tr>
</thead>
<tbody>
<tr>
<td>less:</td>
<td>Realized gain (loss)</td>
</tr>
<tr>
<td>less:</td>
<td>Deferred gain allowed</td>
</tr>
<tr>
<td>less:</td>
<td>Recognized gain (loss)</td>
</tr>
</tbody>
</table>

**Ordinary**

**§1231 (Form 4797)**

**Capital (Schedule D)**

**Personal Use**
Section 1231 Assets

- §1231 assets are not capital assets, but they are given special tax treatment
- Asset must be held > 12 months and used in a trade or business and include:
  - Depreciable real or personal property used in trade or business
  - Timber, coal, or domestic iron ore
  - Livestock (not poultry) held for certain purposes
  - Unharvested crops on land used in a trade or business
§1231 Netting Results

- Net all §1231 gains against losses
- Net §1231 gain is classified as LTCG
- Net §1231 loss is classified as ordinary loss
- This is the best of both worlds!
  - Lower tax rates on gains
  - No limit on losses
Depreciation Recapture

- Prevents taxpayers from receiving the dual benefits of a depreciation deduction and capital gain treatment upon sale of the asset
  - Requires gains to be treated as ordinary to the extent of prior depreciation deductions
    - §1245 recapture
    - §1250 recapture
    - “Unrecaptured depreciation” previously taken on real estate
§1245 Depreciation Recapture

- § 1245 applies to property such as
  - Depreciable personal property (such as furniture, machines, computers and autos)
  - Nonresidential real estate placed in service between 1981-1986 with accelerated depreciation

- Gains are treated as ordinary income to the extent of any depreciation taken
  - Any gain in excess of depreciation is netted with §1231 gains/losses and given beneficial tax treatment

Very complex rules, this is an overview only
Example
Francesca sells depreciable personal property used in her business on 4/1/11 for the price of $50,000. It was purchased for $60,000 four years ago and she has claimed depreciation on the property of $25,000. What is her §1245 recapture?
Example
Francesca sells depreciable personal property used in her business on 4/1/11 for the price of $50,000. It was purchased for $60,000 four years ago and she has claimed depreciation on the property of $25,000. What is her §1245 recapture?

Solution

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>§1245 recapture potential</td>
<td>$25,000</td>
</tr>
<tr>
<td>Adjusted basis ($60,000 – 25,000)</td>
<td>$35,000</td>
</tr>
<tr>
<td>Recomputed basis ($35,000 + 25,000)</td>
<td>$60,000</td>
</tr>
<tr>
<td>Gain realized ($50,000 – 35,000)</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

Ordinary income is lesser of (a) $60,000 recomputed basis – 35,000 adjusted basis or (b) $50,000 amount realized - $35,000 adjusted basis.

The entire gain of $15,000 is ordinary income, instead of §1231 gain.
§1250 Depreciation Recapture

- §1250 applies to depreciable real property
  - Other than that identified as §1245
  - Requires partial recapture of depreciation
  - Gains are treated as ordinary income to the extent of accelerated depreciation taken over straight-line amount
  - Rarely occurs
Unrecaptured Depreciation on Real Estate

- Requires that portion of the gain attributable to depreciation that is not §1250 or §1245 recapture, must be taxed at a rate of 25%:
  - Or 10% if taxpayer in 10% bracket
  - Or 15% if taxpayer in 15% bracket

- Widely seen in practice as many rentals are depreciated and then sold at gain

- Any gain not attributable to depreciation (in excess of original cost) is a §1231 gain
Example
Ella purchases an apartment complex for $7,000,000 on 1/1/91. The property is depreciated straight-line and her accumulated depreciation as of the sale date is $6,100,000. She sells the property on 9/3/11 for $8,500,000. She is in the 33% bracket. What is Ella’s (a) realized gain and (b) how is it split between §1231 gain and 25% rate for unrecaptured depreciation?
**Example**
Ella purchases an apartment complex for $7,000,000 on 1/1/91. The property is depreciated straight-line and her accumulated depreciation (A/D) as of the sale date is $6,100,000. She sells the property on 9/3/11 for $8,500,000. She is in the 33% bracket.
What is Ella’s (a) realized gain and 
(b) how is it split between LTCG and 25% rate for unrecaptured depreciation?

**Solution**
Realized gain = $7,600,000 $8,500,000 - (900,000*)
There was $6,100,000 of depreciation taken; this will be taxed at 25%.
The remainder of the gain = 7,600,000
- 6,100,000
This is taxed as LTCG $1,500,000

* $7,000,000 cost – $6,100,000 A/D = $900,000 adjusted basis
Casualty Gains & Losses: Personal

- Casualty loss is the lesser of:
  - Property’s adjusted basis
  - Decline in the value of the property (repair cost)
- Deductible loss is reduced by:
  - Insurance proceeds received
  - $100 floor (per event)
  - 10% of AGI per year
- Shown as an itemized deduction on Schedule A

- Casualty gain occurs when insurance reimbursement > adjusted basis of property
Casualty Gains & Losses: Business

- Business casualty and theft losses result from damage caused by a sudden, unexpected and/or unusual event
  - For property fully destroyed, deduct adjusted basis
  - For property partially destroyed, deduct the lesser of the property’s adjusted basis or the decline in the value
    - Any insurance reimbursement reduces loss
    - May cause gain
Casualty Gains & Losses: Business

- Treatment of gains and losses depends on holding period
  - Property held one year or less
    - Net gains and losses are treated as ordinary
    - Losses from investment property separately calculated
  - Property held more than one year
    - Net gains treated like §1231
    - Net losses must have components analyzed separately

*Interaction of §1231 and casualty gains/losses from business or investment property is complex – beyond full scope of text*
Casualty Gains & Losses Example

Example
Sherry incurred the following casualty gains/losses and insurance reimbursements in one year, all of the assets are personal property. The fences were destroyed by a hurricane and the boat and trailer by a windstorm. *This was all due to the same storm and is same casualty loss.*

<table>
<thead>
<tr>
<th>Asset</th>
<th>FMV change</th>
<th>Adjusted Basis</th>
<th>Insurance Received</th>
<th>Holding Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fences</td>
<td>$15,000</td>
<td>$8,000</td>
<td>$15,000</td>
<td>5 years</td>
</tr>
<tr>
<td>Boat</td>
<td>$44,000</td>
<td>$50,000</td>
<td>$10,000</td>
<td>6 months</td>
</tr>
<tr>
<td>Trailer</td>
<td>$8,000</td>
<td>$10,000</td>
<td>$0</td>
<td>6 months</td>
</tr>
</tbody>
</table>
Solution

Example
Sherry incurred the following casualty gains/losses and insurance reimbursements in one year, all personal. The fences were destroyed by a hurricane & the boat and trailer by a windstorm. This was all due to the same storm and is the same casualty loss.

<table>
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<tr>
<th>Asset</th>
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Solution
Hurricane results in a casualty gain = $ \ 7,000 \ $8,000 - 15,000
Windstorm results in a casualty loss = ($41,900) = ($44,000 - $10,000) +
Net casualty loss = $ 34,900 = ($8,000 - $0) - $100 floor

The total net casualty loss of $34,900 is further reduced by 10% of AGI.
Installment Sales - Form 6252

- An installment sale occurs when
  - Real or personal property or business/rental property is sold
  - Note is signed and payments are collected over time
- Congress allows taxable gain to be reported as cash received, not when sale completed
  - However, can elect to report all the gain in the year of sale
- Otherwise, use Form 6252, Installment Sale Income
  - Must recapture any §1245 or §1250 first
  - Then calculate gross profit percentage
  - Then multiply percentage by cash received each year
Installment Sales Computations

Taxable Gain  =  Realized Gain  \times  Cash Received

\[ \text{Contract Price} \]

\[ \text{Realized Gain} = \text{Sales Price} - \text{Selling Expenses} - \$1245 \text{ or } \$1250 \text{ Recapture} - \text{Adjusted Basis} \]

\[ \text{Contract Price} = \text{Sales Price} - \text{Assumed Liabilities} \]

Complex installment sale rules apply to taxpayers who regularly sell real/personal property or business/rental property.

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§1031 Like-Kind Exchanges

- No gain/loss recognized when an exchange of like-kind property occurs (deferred gain/loss)
  - Like-kind property transactions occur when
    - Exchanging real property for real property
      or
    - Exchanging personal property for personal property of the same asset class
  - Rules only apply to business or investment property
- May have some recognized gain if “boot” is received
  - Boot is defined as cash received in an exchange or any property (inventory, stocks, bonds, or other securities) that is not like-kind
  - Relief from a liability is also treated as boot received
**Like Kind Exchange Models**

*Realized Gain* = FMV of property received – adjusted basis of property given up

*Recognized Gain* = Lesser of realized gain or boot received

*Basis of New Property* = Adjusted basis of property given up + boot paid – boot received + gain recognized
Example
Barry exchanges his marina for Adolph’s land. The marina has a fair market value of $250,000 and an adjusted basis of $175,000. The land has a FMV of $305,000. Barry also gives Adolph $25,000 cash.

What is Barry’s realized gain, recognized gain, and new basis in the land?
Solution

Example
Barry exchanges his marina for Adolph’s land. The marina has a FMV of $250,000 and an adjusted basis of $175,000. The land has a FMV of $305,000. Barry also gives Adolph $25,000 cash. What is Barry’s realized gain, recognized gain, and new basis in the land?

Solution

Realized gain = $105,000  $305,000 – ($175,000 + $25,000)
Recognized gain =$0 since no boot was received
Basis of land  $175,000 + 25,000 - 0 + 0 = $200,000

$\text{Adjusted basis of property given up + boot paid} - \text{boot received} + \text{gain recognized}$
Involuntary Conversions

- Gain recognition may be deferred if involuntary disposal of property
  - Due to an act of God, theft, condemnation, etc.
  - Insurance proceeds are reinvested in qualified replacement property within two years after close of tax year in which conversion occurred
- Must recognize gain if insurance proceeds exceed adjusted basis of property
- Losses are not deferred
Sale of Personal Residence

- Exclusion on gain of personal home allowed on sale of home
  - For sales 5/6/97 or later
  - If owned and used as principal residence for two of the last five years

- Gain exclusion is up to $500,000 (MFJ) or $250,000 (S)
Sale of Personal Residence

- Sales before 5/7/97 were treated very differently
- Taxpayers didn’t have to recognize gain on sale of house if ‘bought up’ when purchasing new residence
  - Therefore, many taxpayers who had sold one or more principal residences over a period of years have a principal residence with a basis that is far lower than the cost of that residence
  - These taxpayers get ‘fresh basis’ equal to purchase price of newly purchased residence

Beginning in 2009, can’t use ‘loophole’ of moving into previously rented properties every two years and exclude gain – if you rent your residence prior to 2 years of personal use, generally limited to a lesser exclusion